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Topic of the Day

ECB PLANS TO DOUBLE YOUR MONEY

JOHN BEGGS
CHIEF ECONOMIST
AIB GLOBAL TREASURY

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Dublin: AIB International Centre, IFSC.
Cork: 66 South Mall.
London: 12 Old Jewry.
Manchester: 86 King Street.
New York: 405 Park Avenue.

ECB Plans to Double Your Money

AS expected, the European Central Bank raised the official refinancing rate to 3% at today's Governing Council meeting. This represents the fourth increase of 0.25% in official interest rates from the past nine ECB rate setting meetings. It would appear that the ECB is not yet finished this year. Rates are likely to be raised again in October and in December by 0.25% on each occasion.

Though the ECB President, Jean-Claude Trichet, will argue that the ECB has no predetermined path for official eurozone interest rates, I see a growing risk that the ECB will double the official rate from last year's 2% to 4% by the middle of 2007. This is above the market's current expectation, which is that the ECB will push rates no higher than 3.75% by the end of 2007. Indeed, a rate of 3.75% is not even fully priced into the markets for next year. Furthermore, 5 year swap rates have eased lately and are still trading below 4%.

The ECB continues to cite the risks of higher inflation as the main reason for a progressive withdrawal of monetary stimulation in the eurozone. Monetary policy is still accommodative. The real rate of interest is still only about 1.5%, using the core inflation rate as a deflator. The economy is probably growing at an annual rate of about 2.25 % at this stage.

Though the ECB can quote quite a few favourable economic indicators in support of its view that the economy is strengthening, these are largely survey based statistics. Firm evidence in the form of official GDP data are only available for the first quarter of 2006. Data on Q2 2006 will not be published until 14 August. Growth in Q1 2006 came in at 0.6% Q/Q and 2.1% Y/Y. Indications are that Q2 GDP growth could accelerate to at least 0.7% Q/Q and to 2.3% Y/Y. However, the ECB will also take heart from the apparent improvement in the German and wider eurozone labour markets.

There's no doubt that the main driving force behind the ECB's determination to raise official interest rates is its concern about the inflationary risks associated with the growth in the monetary aggregates. Data for June, the latest available, did show some slowdown, albeit from very high rates of growth in the main aggregates. However, lending to the private sector is still growing at an annual rate of 11% with lending for house purchase up 12% year-

on-year. The ECB sees this growth as excessive and is determined to eliminate the inflationary risks inherent in these monetary statistics.

After today's surprise Bank of England announcement of a 0.25% hike in official UK rates to 4.75%, the markets are now factoring in another increase to 5% within the next six months. In the US, there remains a risk that the Federal Reserve will raise rates again next week to 5.5%.

Looking at the table below, it's remarkable how close the "interest rate determining" inflation measures are in the three areas. Furthermore, GDP growth rates are also converging. Growth is slowing in the US. This has been acknowledged by the Fed, yet interest rates could yet go higher. In the UK, the economy has strengthened recently, with quarterly GDP growth moving back to 0.7/0.8% per quarter. A similar pattern could emerge in the eurozone. It's easy to see therefore how the ECB could envisage raising its official rate towards 4% by the first half of 2007.

	Current "interest rate policy related" inflation rate	Q/Q GDP Growth in Q2'06	Official Interest Rate	Direction of Rates
Eurozone	2.5%	0.7% (estimated)	3%	UP
UK	2.5%	0.8%	4.75%	No change
US	2.4%	0.6%	5.25%	No change

John Beggs

Chief Economist

AIB Global Treasury Services

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